1942

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American Institute of Certified Public Accountants. Committee on Accounting Procedure

Accounting Research BULLETINS
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Issued by the
Committee on Accounting Procedure,
American Institute of Accountants,
13 East 41st Street, New York, N. Y.

December, 1942

No. 18

Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)

THIS BULLETIN supplements Bulletin No. 2 as to the treatment of the unamortized discount and issue cost and the redemption premium on bonds refunded (hereinafter referred to as unamortized discount).

SUMMARY STATEMENT

Where unamortized discount on bonds refunded is written off in full in the year of refunding, it is sound accounting to show such charges as a deduction in the income statement in the year of refunding in harmony with the treatment required for income tax purposes. Where any write-off is made through surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise, and there should be shown as a deduction (as hereinafter described) in the income statement for the year of refunding an amount at least equal to such reduction in current taxes.

If the alternative of spreading unamortized discount over a future period is adopted, a charge should be made (as hereinafter described) in the income statement in the year of refunding equal to the reduction in current income tax resulting from the refunding.

DISCUSSION

In Bulletin No. 2 the committee approved alternative treatments of unamortized discount and issue cost and redemption premium on bonds refunded. One alternative was an immediate write-off by a charge in the income statement or to earned surplus.

In Bulletin No. 8 in which the committee pointed out the advantages of a combined statement of income and surplus, it said: "It (the committee) does not here undertake to define proper charges against earned surplus. . . . It approves the current tendency to discourage such charges wherever possible."

A decision to write off the unamortized discount in the year of refunding is based upon the view that these items represent a cost, the benefit from which has expired during the year, or a loss sustained.

Such costs or losses are normally shown as deductions in the income statement.

Unamortized discount is deductible for tax purposes in the year in which refunding takes place and in no other year. If rates are high, charging the entire unamortized discount to surplus and the reduced income tax to income may result in serious distortion.

The committee believes that where the alternative of immediate write-off is accepted, the preferable course will in many cases be to make the charge in the income statement, but that in all cases there should be charged in the income statement (as hereinafter described and in addition to any amount of regular amortization) an amount at least equal to the reduction of current taxes to which the refunding gives rise—otherwise, the anomalous result would be produced that a loss recognized as such would have the effect of increasing the net income reported for the year.

Under the other alternative, the amount of the unamortized discount is regarded not as a realized loss but as a cost which produces a continuing benefit and which should be carried forward and spread over a future period.[1] However, in this case also the reduction in current income taxes resulting from the allowance of these items as a tax deduction is a material fact (unless the amount is relatively insignificant). Accordingly, where this approach is adopted, the committee believes that there should be deducted (as hereinafter described and in addition to any amount of regular amortization) in the income statement of the year of refunding an amount equal to the reduction in current income tax resulting from the refunding, and to treat only the balance as the portion of the cost which is apportionable over a future period.

One method of accomplishing the result required by the two preceding paragraphs would be to charge a portion of the unamortized discount equal in amount to the reduction of income tax, in the income statement of the period in which the benefit of tax reduction is reflected. Another method would be to create a reserve for future taxes by a charge in the income statement equal in amount to such tax reduction. The second method (which is based on recognition of the fact that the immediate reduction of tax is effected only at the price of the loss of a future deduction in respect of a cost which is still carried on the books and will be chargeable to income in future years) has considerable theoretical justification, but the first is simpler and has the sanction of a number of regulatory bodies.

[1] Accounting Research Bulletin No. 2, pp. 15–16.

The statement entitled "Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)" was adopted by the assenting votes of fifteen members of the committee, as it was constituted at the time of the 1942 annual meeting of the Institute. Three members, Messrs. Gilman, Seidman, and Torbet, dissented. Three members did not vote.

The dissenting members point out that the situation covered in this bulletin is only one of many instances in which accounting for general corporate purposes may differ from accounting for income taxes, and they, therefore, feel that there is no justification for singling out unamortized discount for special consideration. They are of the opinion that adjustment should not be made in the income statement to reflect differences between corporate and tax accounting, because the income for the period would thereby be misstated; that reference to such differences by a footnote would ordinarily constitute adequate disclosure.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)